

Free Trade between CARIFORUM and the European Union: Potential Impacts

Introduction

The recent on-going globalization process poses significant challenges to small developing economies such as those in the Caribbean, which are already dealing with a number of issues in their pursuit of sustainable development. For Caribbean countries, the impact of globalization on trade has been reflected in increased liberalization and market-opening policies, especially during the latter part of the 1980s and the 1990s.

Caribbean countries and more precisely, CARIFORUM (CARICOM and the Dominican Republic) have furthered their process of outward orientation by signing in 2000 jointly with other ACP countries the Cotonou Agreement with the European Union. The main objective of the Cotonou Agreement is the 'eradication of poverty in a consistent manner with the objectives of sustainable development and the gradual integration of the ACP countries in the world economy'. With the Cotonou Agreement, ACP countries have agreed to turn their non-reciprocal trading arrangement with Europe into fully reciprocal regional integration areas in the form of Economic Partnership Agreements (EPAs).

CARIFORUM countries have agreed to establish the modalities and time table for trade liberalization with the European Union before the end of 2006. New trade rules would enter into force in 2008 and be fully implemented by 2020. In December 2005, ECLAC organized an expert group meeting to discuss and analyse key issues pertaining to Status of trade relations between the European Union and the Caribbean under the Cotonou Agreement such as the potential impacts of the EPAs

This **Issue Brief** contains excerpts from the background documents and discussions of that meeting.

Background

The European Union maintains a special trade relation in the form of a model of cooperation with a group of countries in Africa, the Caribbean and the Pacific Ocean, called the ACP group. This goes back to 1964, with the first of two Yaoundé Agreements between the European Economic Commission and mostly former French colonies in Africa. With the admission of the United Kingdom to the EEC in 1972 the special trade relation was expanded to include former British colonies. Four Lomé Conventions (1975-1999) provided for non-reciprocal market access, a stabilization mechanism for export prices as well as financial, technical and industrial cooperation mechanisms. Attached to the Conventions were protocols containing special provisions for access to the European market for sugar, bananas, rum and meat and veal.

The Lomé Conventions underpinned a new model of cooperation based on trade preferences and aid flows for developing countries. A quarter of a century later, the

Convention was discontinued and replaced by the Cotonou Agreement. Lomé had not been successful enough in stimulating ACP countries' export growth to Europe and neither had it helped to diversify their export structure. As the global community progressed toward liberalizing trade, the Lomé trade privileges became less advantageous and were found to be at odds with principles such as non-discrimination, agreed by GATT contracting parties and later WTO member countries. The European Union was forced to obtain GATT and WTO waivers. Pressure from other developing countries to change Europe's common agricultural policies and the special provisions for ACP countries mounted.

The Cotonou Agreement (2000) between the European Commission and the ACP group of countries aims to put in place by 2008 a trade arrangement that is fully compatible with the rules of the World Trade Organization and that is embedded in regional Economic Partnership Agreements (EPA) providing aid, technical assistance and collaboration for development. Meanwhile, the Lomé Convention and its necessary WTO waiver were extended until 2007. The Caribbean EPA negotiations are conducted by the Caribbean Regional Negotiating Machinery (CRNM) on behalf of CARIFORUM. The negotiations started in April 2004. During 2006, an agreement on the approach to trade liberalization should be obtained.

What will change?

With respect to trade, the conditions governing access for European goods and services on the Caribbean market and vice versa will, in principle, undergo profound changes. Regarding merchandise trade, access for Caribbean goods on the European market is already mostly duty-free and conditions will therefore not significantly improve. The EPA's will bring, however, a lowering of tariffs for European goods entering the Caribbean markets. Regarding services, discriminatory requirements and other regulatory barriers are at present widely used. Free trade would improve market access in both directions. Separate issues are the changes in the sugar and banana protocols. Preferential access conditions for Caribbean producers will be severely eroded.

Regarding the lowering of duties on imports of European products into the Caribbean market, it should be borne in mind that customs service charges and consumption taxes are affected by trade liberalization. As import duties have decreased customs charges have risen in most countries acting de facto as an import duty. Furthermore, Caribbean countries may safeguard import duties of a few tariff lines that are particularly important as sources of revenue. Only a relatively small number of items account for most revenue and thus, by safeguarding those items, trade liberalization may be implemented for "substantially all trade", meaning 95% of tariff lines, without essentially affecting revenue. Furthermore, Europe is not the most important supplier of imports on the Caribbean market; the United States is. In essence, lowering of import duties on products of European origin will not change much, in the overall picture. Nevertheless, for specific industries in some countries the changes may make all the difference.

Different is the situation for trade in services. At stake is the possible elimination of all requirements (visas, licences, permits or economic needs tests) impeding market access for individual suppliers, intra-corporate transferees, business visitors, professionals and support personnel from Caribbean countries to the EU and vice versa. Also, recognition of professional credentials, elimination of requirements for local presence and other discriminatory rules will be discussed. Conditions governing Caribbean access to service markets in Europe, and vice versa, could indeed undergo important changes.

Changes in the access conditions on the European markets for Caribbean sugar and banana producers are already underway, related to the reforms of the Common Agricultural Policy and the WTO commitments of Europe. Although closely related, changes in the commodity protocols will take place regardless of the results of the EPA negotiations.

The Sugar Protocol guarantees that ACP countries have access the EU market for fixed quantities of sugar at preferential prices over an indefinite period of time. The prices are to be negotiated every year. The current sugar regime ends on the 30 June 2006. The European Union, in the context of the reform of its common agricultural policy, has announced a 36% price reduction over the next four years beginning in 2006/2007. Despite the reform the EU intervention price will still remain well above the world market price.

The Banana Protocol consisted of a system of tariff and tariff preferences as well as quotas. The tariff-quota and license system were expected to come to an end by January 2006 and replaced by a tariff-only regime consisting in the application of a bound duty of 230 Euros per metric tonne.

What are the potential impacts?

Changes in global and European trade rules have eroded and will continue to erode CARIFORUM trade preferences. The granting of duty-free access for least developed countries in 2005 is a case in point. Changes in the sugar and banana market arrangements are another. These changes will happen regardless of the EPA negotiations. In consequence, CARIFORUM countries are likely to experience losses in export revenue from the ongoing erosion of trade preferences. The EPA-related decrease in tariffs may also lead to an increase in imports. Together, these trends may affect growth and employment. An impact study on the sugar industry for example, found a negative impact on revenue, export earnings, production and employment as a consequence of less preferential access.

To obtain a preliminary assessment of the sign and magnitude of the impact of free trade with Europe on economic growth of Caribbean economies, the ECLAC study presents a model based on the notion that these countries face a considerable external constraint. Their external performance, in terms of exports as well as attraction of foreign investment, limits growth to a rate below that warranted by internal conditions. This was found to be true for several countries in the region. Calculations with this model

conclude that tariff reductions and import growth are of lesser concern to the region than are export competitiveness and the capacity to attract foreign capital. The table below reflects the outcome of computations.

Table 1: The impact of free trade with Europe on the growth rate of Caribbean countries

Equilibrium rates of growth						
Countries	1 Terms-of-trade	2 Income elasticity	3 Actual rate Of growth	4 BPC Growth rate	5 EPA Scenario I	6 EPA Scenario II
Barbados	2.09	2.92	1.14	1.08	0.87	0.91
Dominica	0.68	2.65	2.50	3.26	3.45	3.52
Grenada	0.84	1.19	3.68	5.20	4.92	5.01
Jamaica	2.31	0.81	1.59	4.85	3.45	3.51
St. Kitts and Nevis	0.18	1.72	4.58	4.45	4.41	4.50
St. Lucia	0.66	1.22	3.79	4.93	4.92	5.01
St. Vincent and the Grenadines	0.01	1.95	4.47	2.83	2.83	2.88

Column 3 contains the average rate of real GDP growth and column 4 the rate of GDP growth which is consistent with the current account equilibrium, including the terms of trade effect. The latter is the benchmark against which the impact of a free-trade arrangement with Europe can be measured.

The first EPA scenario, column 5, hypothesized a significant tariff reduction of 20% applied to imports from Europe. The second scenario, column 6, added a 2% increase in the rate of real export growth. While the first scenario focuses purely on changes in merchandise trade regime, the second scenario also takes into account the possibility of an increase in the competitiveness of Caribbean exports to Europe, as a possible consequence of the development aspects of the EPA's as well as increased competitiveness services exports.

The potential EPA benefits are highlighted in a Sustainability Impact Assessment study commissioned by the European Union, which concludes that EPA will stimulate growth in tourism services exports. In this study, the production of tourism services, its contribution to GDP and government revenue as well as to employment is expected to be enhanced by an EPA, provided appropriate policies and reforms as well as a Common Market are established.

The difference in growth rates of columns 4, 5 and 6 are very small, except for Jamaica, meaning that the liberalization scenarios here contemplated would not have a significant impact on the equilibrium growth rate consistent with the balance-of-payments equilibrium.

Whereas a free trade agreement with Europe as envisaged in the EPA negotiations would probably not have a significant impact on the overall growth rate of Caribbean

economies, it will very likely have profound consequences in particular places and industries. In Guyana for example, the sugar industry accounts for 18% of total GDP, 57% of agricultural GDP and 30% of export earnings. The socio-economic contribution is significant as it shelters a quarter of the population which depends on the industry and its linkages. It also maintains rural stability by reducing the migration to urban areas. The effects of the 36% price cut will be manifold: loss in foreign exchange earnings and thus ability to service debt payments; fall in government revenues; destabilization of rural communities with the rise in unemployment, greater migration to the urban areas and increased poverty and crime; and the environmental costs as the industry currently maintains the drainage and irrigation systems.

Priority issues for the Caribbean

The proposed Economic Partnership Agreement with Europe entails opportunities and threats for particular industries in certain countries. Overall, its impact on growth should be rather small but positive.

EPAs will provide an incentive for CARICOM to accelerate and refine its regional integration process. Regional integration is seen as a pre-condition for extra-regional integration. The region can be a training ground for firms to become competitive at the extra-regional level. The empirical evidence shows there is no absolute divide between the firms that export intra-regionally from those that export extra-regionally. That is, according to the results there is scope for expanding trade through Learning-by-Doing processes where the Learning-by-Doing would occur at the intra-regional level allowing firms to acquire the skills and competitiveness to export to extra-regional trade partners.

It is also clear that EPAs will accentuate the economic tendencies that are entrenched in the region. These include the stagnation of agriculture, the virtual disappearance of the manufacturing sector in some of the smaller states and the continued dynamism of the services sector. EPAs should address the dangers of economic duality, expressed in the marginalization of the traditional sectors of the economy, including light manufacturing. Key to avoid this is to ensure the crowding-in of foreign and domestic investment. Foreign direct investment should translate into greater domestic investment, or in other words accessing foreign savings should result in greater levels of overall investment.

The EPAs will provide an opportunity to improve the economic environment for firms to deepen the process of adaptation to a changing global environment. Firms in the Caribbean have begun a process of restructuring, including the expansion of their installed capacity, a change in the methods of production and diversification in their product lines. These are crucial decisions that will determine the future Caribbean growth path. The economic policy environment should provide the signals and the tools for firms to be successful in the restructuring process. The EPA's could be used to improve this environment in the Caribbean. That way, the positive outcomes will amply compensate negative consequences and losses.